United States Court of Appeals

for the Second Circuit

REPLY BRIEF

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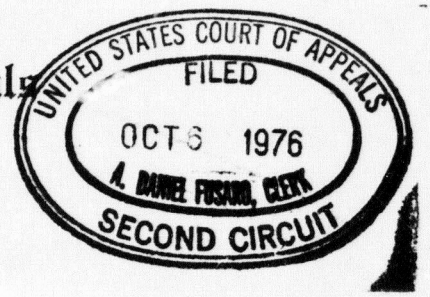
76-7270



United States Court of Appeals
For The Second Circuit

Docket No. 76-7270

SOPHIE RUSKAY *et al.*,
Plaintiffs-Appellants,

versus

CHAUNCEY L. WADDELL *et al.*,
Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

REPLY BRIEF FOR PLAINTIFFS-APPELLANTS

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Defendants urge "the law's intolerance of repetitious litigation" (DBr 17).* They ignore the more fundamental rule that res judicata "be so tempered that litigants receive at least one fair day in court"; 1B Moore's Fed. Pr. (2d Ed. 1972), ¶ 0.410[1], p. 1155.

The sale-of-office claim never had that day in

*Defendants' brief is cited herein as "DBr", plaintiffs' main brief as "PBr".

court. The Horenstein-Ruskay plaintiffs did not allege the claim. The settlement notice, with all its prolific detail, did not recite the claim. Judge Lasker's comprehensive settlement decision did not so much as mention it. There is no suggestion in the record, let alone proof, that the claim could have been asserted. To treat it now as a matter adjudicated in the prior litigation would pervert res judicata.

According to defendants, "the deciding factor, recognized by all counsel and Judge Lasker, which motivated the settlement" was to discharge all possible claims to the proceeds of the W&R stock sale (DBr 12, 14). Not a word in the record supports this assertion.* Whatever may have "motivated" the Horenstein-Ruskay parties to settle, the scope

*Defendants' only citation (DBr 12) is to a statement of Horenstein-Ruskay counsel that the stock sale furnished "the opportunity of settling this litigation" (A393). We fail to see how this can be read as reflecting an intention to include a sale-of-office claim in the settlement. In any case, counsel's explanation of the settlement opportunity was that "[s]uddenly, these lawsuits became burdens to the defendants, far in excess of the burdens theretofore possibly imposed by the law or the facts" (A393). Plainly, the "burdens" thus referred to did not arise from any sale-of-office claim for, on defendants' own view, Horenstein-Ruskay "chose not to assert" the sale of office "because they thought the theory to be precluded" (DBr 26; see DBr 8 n. 11).

of res judicata is not determined by their unexpressed motives, but by the terms of the settlement notice and the judgment; and those expunged no claims except claims "which are or might have been asserted with respect to the matters and transactions alleged in said complaints" (A230; see A205-06; emphasis added). The sale of office was not alleged in any of the complaints.

As previously shown, res judicata fails for three separate and independent reasons (PBr 21, 32B, 38). Defendants' arguments do not undercut any of them.

I.

RES JUDICATA FAILS BECAUSE THE CLAIMS HERE AND IN HORENSTEIN-RUSKAY ARE NOT THE SAME.

1. The first question bearing on the identity or difference of the claims is whether Horenstein-Ruskay actually alleged the sale-of-office claim. We have shown that they did not (PBr 22-23). What they did allege was that part of the $80 price for the W&R stock was "attributable to", or a "capitalization of", W&R's illegal brokerage profits and was recoverable as part of those profits. Judge Metzner in the present case so read the supplemental complaints (A445, 447);

so did Judge Tyler in Horenstein-Ruskay (A340); and so did the Horenstein-Ruskay parties (A388, 409). Indeed, the point is no longer controverted, for defendants themselves proclaim that the Horenstein-Ruskay plaintiffs "chose not to assert a 'sale of office' theory" (DBr 26).

2. Nor did Horenstein-Ruskay allege the facts necessary to support a sale-of-office claim. Defendants (DBr 9, 20 n. 22, 27) point to Ruskay's allegation that the Continental purchase offer was "subject to the approval by the shareholders of the Fund of the change in control of W&R" (A172-73); but that allegation certainly did not suggest a claim for the sale of office. The essence of that claim is defendants' acceptance of personal gain for using their fiduciary influence with the stockholders and directors of the Fund to secure the reinstatement of the service agreements (PBr 24-26). Accordingly, the present complaint alleges that the management of the Fund - which included the individual defendants and W&R - recommended to the stockholders the reinstatement of the advisory agreement; the stockholders followed that recommendation; for this successful use of their fiduciary influence defendants were paid to the tune of $62 million (A9-12). Nothing of the sort was alleged in

Horenstein-Ruskay.

In an attempt to fill this gap, defendants recite their denials in Horenstein-Ruskay that they were under any liability to the Fund (DBr 9, 26-28). The theory seems to be that these denials put the sale-of-office claim in issue. The short answer is that the claims affected by res judicata are determined by the allegations of the complaint, not by the denials of the defendants. Herendeen v. Champion Internat. Corp., 525 F. 2d 130, 134 (2d Cir. 1975) (court must determine "what the plaintiff claimed and what the court decided in the first action"); Williamson v. Columbia Gas & El. Corp., 186 F. 2d 464, 467 (3rd Cir. 1950), cert. denied, 341 U.S. 921 (1951) ("The best way to find out what is involved in the two actions is to look at the claims made by the plaintiff"); F.L. Mendez & Co. v. General Motors Corp., 161 F. 2d 695, 698 (7th Cir.), cert. denied, 332 U.S. 810 (1947) ("the question what wrong is sued on must be determined from the allegations in the respective plaintiff's pleadings").

Defendants finally suggest that the Horenstein-Ruskay pleadings were amended "by consent" at the settlement hearing so as to add the sale-of-office claim (DBr 14). The

contention is without the slightest basis in fact, and is untenable as a matter of law; the addition of a new claim at the hearing would have been an amplification of the settlement requiring a new notice to the stockholders of the Fund.*

3. As previously noted (PBr 23), the failure of the Horenstein-Ruskay plaintiffs to assert a sale-of-office claim is not the end of the matter. Res judicata might, nevertheless, be a defense if the claims here and in the prior litigation had "the requisite measure of identity" (Herendeen, supra, 525 F. 2d at 133) and if, in addition, the sale-of-office claim "could have been asserted" in the prior litigation.** (Since these actions are stockholders'

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*Defendants' authority (DBr 14), Hardy v. Bankers Life & Cas. Co., 232 F. 2d 205, 209 (7th Cir.), cert. denied, 351 U.S. 984 (1956), is inapposite since it involved the settlement of an individual action (not of a derivative or class action).

**The two requirements are cumulative; if the claims are not "the same", res judicata does not apply, even if it were thought that the Horenstein-Ruskay plaintiffs could have sued for the sale of office and even if they had deliberately refrained from doing so. Herendeen, supra, 525 F. 2d at 134-35, discussed at PBr 30-31, and additional authorities cited at PBr 31n. The dictum from Ritchie v. Landau, 475 F. 2d 151, 156 n. 5 (2d Cir. 1973), which defendants invoke (DBr 21), simply refers to the familiar rule that claims arising "out of the same transaction" should be asserted in a single action. The claims here and in Horenstein-Ruskay arise out of altogether different transactions (PBr 27-28 and pp. 7-8, below).

suits, the adequacy of the settlement notice is a third requirement.)

At this point we address defendants' contention that the sale-of-office claim is "the same" as the claim for the brokerage abuses alleged in Horenstein-Ruskay. The various tests for determining whether causes of action are the same for res judicata purposes (Herendeen, 525 F. 2d at 133-35) have been amply discussed (PBr 26-32); we add only what follows.

In applying res judicata, this Court, like others, is guided by a simple practical rule. Claims are deemed to be "the same", or to be separate and distinct, depending on whether they arise from the same or from different operative facts or transactions. Thus Herendeen, supra, 525 F. 2d at 135 (quoting from an earlier case):

> "The true distinction between demands or rights of action which are single and entire, and those which are several and distinct is, that the former immediately arise out of one and the same act or contract, and the latter out of different acts or contracts."

Accord: Saylor v. Lindsley, 391 F. 2d 965, 969 n. 6 (2d Cir. 1968) ("same operative facts", "same disputed

transactions"); Ritchie v. Landau, 475 F. 2d 151, 156 n. 5 (2d Cir. 1973) ("same transaction").

The operative facts or transactions from which the Horenstein-Ruskay claims arose were the brokerage abuses. The plaintiffs' demand in their supplemental complaints to impress a trust on the sales price of the W&R shares was simply an attempt to follow or trace the proceeds of the original wrong. Without the brokerage abuses there was no basis for impressing a trust. Horenstein-Ruskay did not allege a sale of office; nor did they have to prove it in order to prevail.

The opposite is true in the case at bar. The operative facts or transactions from which the present claim arises are defendants' use, for personal gain, of their influence with the stockholders and directors of the Fund to secure the reinstatement of the service agreements. No brokerage abuses are alleged; none will have to be proved. The difference between the operative facts or transactions here and in Horenstein-Ruskay could not be more radical.

In each of the numerous cases cited by defendants, the finding of res judicata related to claims arising from

identical operative facts or transactions. Thus, in Chicot County Drainage District v. Baxter State Bank, 308 U.S. 371 (1940) - a case heavily relied on by defendants (DBr 20, 26) and by the Court below (A447) - the plaintiffs sued on defaulted bonds of the defendant District. The defense was that the bonds had been cancelled by a judgment in a statutory proceeding for readjustment of the District's debts, to which the plaintiffs were parties (p. 375). The plaintiffs replied that the statute under which the readjustment proceeding had been conducted was unconstitutional; but that reply was overruled because the point could have been asserted in the earlier proceeding. Plainly the claim of the plaintiffs in the action and in the earlier proceeding arose from the same operative facts, their ownership of the defaulted bonds of the District. Chicot County is of no help whatever in deciding whether the claims here and in Horenstein-Ruskay are "the same", i.e., whether the operative facts in the two cases are the same.

An exhaustive review of defendants' other authorities would unduly lengthen this brief, but a few are discussed in the margin to show that each involved successive suits

based on identical operative facts or transactions.* None of these or of the other cases cited by defendants sheds any light on the identity or difference of the transactions here and in Horenstein-Ruskay. As a matter of plain fact, the brokerage abuses there and the sale of office here are

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*Baltimore Steamship Co. v. Phillips, 274 U.S. 316 (1927), was a seaman's personal injury action based on the same injury and the same incident on which he had predicated an earlier unsuccessful suit. The "transaction" was thus the same in both cases, even though one of the suits asserted the use of defective appliances by the defendant, whereas the other alleged the improper operation of the appliances.

Williamson v. Columbia Gas & Elec. Corp., 186 F. 2d 464 (3d Cir. 1950), cert. denied, 341 U.S. 921 (1951), involved successive antitrust actions based on the same conduct of the defendants; the only difference was that one action invoked the Sherman Act, the other the Clayton Act.

Clarke v. Redeker, 406 F. 2d 883 (8th Cir. 1969), involved successive suits by a state college student who claimed that he was improperly charged excessive tuition fees; the first suit sought an injunction, the second merely changed the remedy by seeking damages.

In Moreno v. Marbil Products, 296 F. 2d 543 (2d Cir. 1961), the plaintiff charged in successive actions that he had unjustly been denied the first prize in a contest. The first action was based on breach of contract, the second added allegations of conspiracy.

In Norman Tobacco & Candy Co. v. Gillette Safety Co., 295 F. 2d 362 (5th Cir. 1961), the plaintiff complained in successive actions of Gillette's refusal to sell it razor blades; the only difference was a change in theory, the first suit charging a breach of contract, the second a violation of the antitrust laws.

so remote from each other in time and subject matter that an attempt to treat them as identical would border on the absurd.

4. As a final point, defendants argue that the claims here and in Horenstein-Ruskay are the same because both seek the same remedy: the recovery for the Fund of parts (although not the same parts) of the proceeds from the sale of the W&R stock. Defendants have cited no authority, and we have found none, for the proposition that two claims, even though based on wholly different transactions, are "the same" for res judicata purposes just because they seek the same relief. Indeed, Herendeen, supra, 525 F. 2d 130, strongly militates against any such theory (PBr 31); and we now add that United States v. The Haytian Republic, 154 U.S. 118, 128 (1894), squarely rejects it.

In The Haytian Republic, the Government brought a libel in the District of Washington seeking the forfeiture of a vessel on the ground of illegal smuggling activities at specified dates in 1892 and 1893. While this action was pending, the Government brought a second libel for the forfeiture of the same vessel in the District of Oregon, alleging similar

smuggling activities during the same period but at other places and on other days. In that second suit, a claimant raised the defense of "other action pending"; the Supreme Court overruled it. The case is here relevant because the Supreme Court held that "the elements constituting the thing adjudged [i.e., res judicata], and those necessary for the plea of 'other suit pending', are identical" (p. 124).

Since the smuggling activities alleged in the two actions had occurred at different places and dates, the Supreme Court held that the underlying transactions and, hence, the Government's claims in the two suits were not the same. The Court also held that, the claims being separate and distinct, it was not necessary for the Government to assert them in a single action. Finally, the Court turned to, and overruled, the contention that the claims in the two suits were the same because they sought the same relief, the forfeiture of the vessel (154 U.S. at 128):

> "There is no force in the argument that, as the suit in Washington claimed the forfeiture of the vessel and the suit in Oregon claimed the same thing, there was a practical identity between them. The fallacy results from a failure to distinguish between the right and the remedy. True the remedy sought in Washington was the forfeiture of the

> vessel, and the same remedy was invoked in Oregon, but the causes of action upon which the remedy was prayed in the two cases were entirely different. As we have seen, not only identity of relief, but identity of cause of action, is essential to the plea of pending suit, and both are also necessary to the efficacy of the plea of the thing adjudged."

The analogy to the case at bar is plain. Here, as in The Haytian Republic, the relief sought in the two suits has some similarity. But here, as there, the claims in the two suits arise from different transactions or operative facts. The Supreme Court held that, despite the identity of the remedies sought in the two actions, the difference in the transactions giving rise to the claims destroyed the identity of the claims for res judicata purposes. The same conclusion, we submit, follows in the present case.

II.

RES JUDICATA ALSO FAILS BECAUSE THE SALE-OF-OFFICE CHARGE COULD NOT HAVE BEEN ASSERTED IN HORENSTEIN-RUSKAY.

Assuming, arguendo, that the claims here and in Horenstein-Ruskay are the same, res judicata is, nevertheless, no defense because the sale of office could not have been asserted as a ground of recovery in Horenstein-Ruskay. The

sale of office occurred after the commencement of the Horenstein-Ruskay actions; it could, therefore, have been alleged only by way of supplemental complaint, requiring the District Court's discretionary permission, FRCP 15(d); and there is no way for defendants to prove that such permission, if sought, would have been granted. Burns Bros. v. The Central Railroad of New Jersey, 202 F. 2d 910, 913-14 (2d Cir. 1953), and other cases cited (PBr 32B-38).

1. Defendants' opposing arguments (DBr 29-30) are less than clear. They seem to suggest that Judge Tyler, having permitted an allegation concerning the sale of the W&R stock to be pleaded, would, if asked, also have permitted other allegations connected with that stock sale, such as the sale of office (DBr 29). The argument, speculative on its face, is inconsistent with the whole tenor of Judge Tyler's decision (A338). As previously shown (PBr 11-12, 15-16), Horenstein had moved to add two supplemental counts to his original complaint (A281, 289, 305, 308). The proposed second count alleged that the W&R stock sale would cause W&R's brokerage subsidiary, KCSC, to lose its seat on the Pacific Coast Stock Exchange, to the detriment of the Fund (A305-07). Although this proposed count was thus directly connected with the W&R

stock sale, Judge Tyler disallowed it because it was unrelated to the brokerage abuses (A343-44; see PBr 15-16). A sale-of-office claim would likewise have been unrelated to the brokerage abuses; there is thus no reason to believe that Judge Tyler would have allowed it to be pleaded if his permission had been sought.

We do not presume to state with certainty how Judge Tyler would have ruled if an application to plead the sale-of-office claim had been made to him. But we do say - as did this Court in a comparable case - that "it is impossible to know what would have been the result" (Burns Bros., supra, 202 F. 2d at 913-14). Since defendants have the burden of proof on this question and cannot sustain it (id.), the uncertainty must be resolved against them.

2. Defendants' other argument on this branch of the case seems to be that the Horenstein-Ruskay defendants could have consented to a supplemental complaint alleging the sale of office and that, in such case, Judge Tyler presumably would have approved (DBr 29-30). The trouble is that Horenstein-Ruskay never sought to assert the sale-of-office claim; consequently, the Horenstein-Ruskay defendants never did consent to its assertion; and it is impossible for defendants to prove

that they would have consented if an attempt to allege the sale of office had been made.

What happened is quite simple, although defendants' brief (29-30) obscures it. Judge Tyler's decision permitted Horenstein to file his third proposed count as a supplemental complaint (A343); that count clearly did not allege a sale of office (A107-10; PBr 12). Ruskay then moved for leave likewise to file a supplemental claim (A345, 352); concededly, this was "essentially the same claim" as Horenstein's (DBr 30). On June 27, 1969, defendants consented to Ruskay's motion (A355-56), presumably because Judge Tyler's decision rendered opposition futile.* Nothing in these events, and nothing otherwise in the record, suggests that defendants consented to the assertion of a sale-of-office claim or that they would have consented if asked to do so.**

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*Defendants' consent predated the December 24, 1969 settlement stipulation (A197) by half a year. Defendants' contention that their consent was intended "to insure the breadth and effectiveness of the settlement" (DBr 29) is thus fanciful, and it is without support in the record.

**Needless to say, "a post hoc reconstruction of [defendants' hypothetical] mental processes as a defense" would be impermissible; Fogel v. Chestnutt, 533 F. 2d 731, 750 (2d Cir. 1975; interpolation added).

III.

RES JUDICATA ALSO FAILS BECAUSE THE SETTLEMENT NOTICE DID NOT INFORM THE STOCKHOLDERS OF THE FUND THAT A CLAIM FOR THE SALE OF W&R'S OFFICES WAS TO BE SETTLED.

We again assume, for purposes of our present discussion, that the claims here and in Horenstein-Ruskay are, for res judicata purposes, the same.* Nevertheless, the Horenstein-Ruskay settlement and judgment do not bar the sale-of-office claim because the settlement notice did not warn the stockholders that such a claim was to be included in the settlement.

1. Defendants do not dispute that the settlement of a derivative suit (such as Horenstein-Ruskay) requires a notice to stockholders; that the notice must be adequate; and that a judicially approved settlement based on an inadequate notice does not operate as res judicata (see PBr 38-40). Defendants do contend that the settlement notice in Horenstein-Ruskay was adequate (DBr 13-17).

*If the claims are not the same (Point I, above), res judicata fails on that ground alone, and it is then unnecessary to consider the settlement notice.

We defy anybody, lawyer or layman, to read this settlement notice (A203) and to gather from it any hint that a sale-of-office claim was to be settled. The notice described the Horenstein-Ruskay claims in detail. The summary of the alleged brokerage abuses covered more than half of a closely printed page and enumerated a multitude of individually itemized charges (A203-04). The notice then recited a variety of defenses to the brokerage claim (A204); it summarized another Horenstein-Ruskay claim not here relevant and the defenses thereto (A204-05); and it finally turned to the Horenstein-Ruskay supplemental complaints (A205), which it described as alleging -

> "that the defendants Waddell, Merriman and Roach arranged to sell a majority of the voting shares of W&R held by themselves and members of their families at a price of $80 per share; that such price was largely attributable to the profits derived by W&R from the acts, transactions and practices complained of in their principal complaints; and that the proposed sale should be enjoined or the proceeds thereof sequestered for the benefit of United." (A205)

This was followed by a summary of the defenses to the supplemental complaints (A205).*

*Since the scope of res judicata is determined by the complaints (p. 5 , above), the recital in the notice of the defenses is, for present purposes, not relevant.

By no stretch of imagination could a reader of this notice have guessed that the settlement was to include a claim that the defendants, for private gain, had used their fiduciary influence with the stockholders and directors of the Fund for the reinstatement of the service agreements.

Defendants' brief (DBr 8, 20 n. 22), purporting to analyze the supplemental complaints, emphasizes ¶ 67 of Horenstein (A108) and ¶ 35 of Ruskay (A173); both of these paragraphs alleged that the W&R stock sale was a breach of defendants' fiduciary duties. According to defendants, these allegations were enough to assert the sale-of-office claim.* Assuming, arguendo, that Horenstein ¶ 67 and Ruskay ¶ 35 had this important and far-reaching effect, one might expect to find their substance in the settlement notice. Actually, however, the notice contained nothing of the sort. It did not recite any claim that the W&R stock sale was a breach of

*As we have shown (PBr 22-23), the bare allegation of a fiduciary breach was meaningless without supporting fact allegations; and the fact allegations showing a fiduciary breach referred to the brokerage abuses, not to a sale of office.

defendants' fiduciary duties. All it said was that the $80 sales price for the W&R shares was largely attributable to the illegal brokerage transactions and should, therefore, be sequestered for the benefit of the Fund. Even on the most expansive view of the settlement notice, it did not make the slightest reference to a sale-of-office claim.

2. Defendants argue that the stockholders of the Fund could have discovered the sale-of-office claim by examining the Horenstein-Ruskay pleadings. The stockholders had no ground to resort to the pleadings except to clear up "ambiguities" or manifest omissions of the notice, Grunin v. International House of Pancakes, 513 F. 2d 114, 122 (8th Cir.), cert. denied, 423 U.S. 864 (1975). The Horenstein-Ruskay settlement notice contained no ambiguities or manifest omissions. On the contrary, its description of the claims alleged was specific and detailed. Stockholders reading the notice had no reason to suspect that an additional claim, unrevealed by the notice, was lurking in the pleadings. A settlement notice is designed to inform the stockholders, not to become a trap for the unwary.

3. According to defendants, the settlement notice

advised the stockholders that the settlement was intended as a final disposition of all claims to the proceeds from the W&R stock sale (DBr 10-11, 14-15). We find no such language either in the notice or in the settlement itself. Only those claims or controversies were to be disposed of which were or might have been asserted on the basis of the matters "described or referred to in the various pleadings of the plaintiffs" (A205, 206). The scope of the settlement was thus determined by the "pleadings of the plaintiffs". The notice purported to give a complete and detailed description of those pleadings. The description included neither the sale of office nor the facts constituting such a sale.

Defendants point out correctly that courts favor or encourage the compromise of disputes; but defendants' further assertion that, for res judicata purposes, the scope of a prior settlement is accorded a "sympathetic" (presumably meaning expansive) interpretation is without any support in the authorities they cite (DBr 14).* A settlement, like any

*Defendants insinuate to us a contention that derivative settlements should be accorded only "a hostile reception" (DBr 13). Here, as elsewhere throughout their brief, defendants reap a rich harvest of strawmen by rebutting arguments we never made.

other contract, is to be interpreted in accordance with the intention of the parties as reflected in the terms of the agreement. Nothing in the record indicates that the Horenstein-Ruskay parties intended to release any claims other than those based upon, or derivable from, the matters alleged in the complaints; and that is precisely what Judge Lasker's judgment provided (A228, 230).

4. We note in conclusion that defendants' view of the settlement notice raises a problem of some gravity. Defendants say that they intended the settlement to extinguish all claims of the Fund, "however phrased", to the proceeds of the W&R stock sale (DBr 14). This included, they say, the sale-of-office claim.* Nevertheless, defendants caused the issuance of a settlement notice which was carefully framed to avoid any hint that defendants intended to secure a release of the sale-of-office claim. Elementary fairness, we submit,

*Defendants were, at the time, familiar with that type of claim; witness the citation of SEC v. Insurance Securities, Inc., 254 F. 2d 642 (9th Cir.), cert. denied, 358 U.S. 823 (1958), in defendants' settlement brief (A434).

required defendants to reveal to the stockholders what they knew or intended. Their duty of full disclosure was enhanced by their fiduciary relationship to the stockholders of the Fund. To reward defendants for their lack of candor, if not worse, by according them the benefits of res judicata would permit them to sneak into forgiveness and would defeat the purpose of the Federal Rules and of fundamental due process.

Dated: October 6, 1976

Respectfully submitted,

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